bae urban economics

Draft Interim Memorandum

To: Margot Ernst, City of Walnut Creek

CC: James Carney, M-Group

From: Stephanie Hagar

Date: June 21, 2019

Re: Interim Financial Feasibility Analysis – Walnut Creek Density Bonus Ordinance

This memorandum presents a high-level summary of findings from a static proforma analysis that BAE Urban Economics (BAE) conducted in the first quarter of 2019 to evaluate the impact of a density bonus on the financial feasibility of new residential development in Walnut Creek, California. These interim findings will be incorporated into a full financial feasibility analysis related to the City's Density Bonus Ordinance, which will evaluate potential changes to the ordinance, provide detailed information on methodology, and a full set of findings. The interim findings presented in this memorandum are intended for internal discussion between the consultant team and City staff.

Methodology

This analysis involved preparation of static proforma financial feasibility models for hypothetical townhouse ownership developments and multifamily rental developments in Walnut Creek. The static proforma models represent a simplified form of financial feasibility analysis that developers often use at a conceptual level of planning for a development project, as an initial test of financial feasibility for a development concept, to screen for viability. For each of the two residential product types, the analysis included an evaluation of one project that complies with baseline zoning requirements and one project that receives a density bonus and other incentives or concessions in exchange for providing affordable units on site, based on the City's existing Density Bonus Ordinance.

The proforma models are structured to calculate the residual land value associated with each development program. The calculation for residual project value starts with the market value of the completed project at stabilization and then deducts total development costs and developer profit. The residual land value approximates the maximum amount that a developer should be willing to pay for a given site, based on the value of the project that the developer would build on that site. Developers typically seek to pay less than the full residual land value

to allow for transaction costs for the property sale, financing costs, and other expenses. In addition, a developer will offer a price that is lower than the residual land value if possible, in order to obtain additional profit from a project. In general, a high residual land value indicates high profit potential, and therefore a more attractive development opportunity relative to a project that generates a low residual land value.

BAE formulated assumptions for the proforma analysis using information from a variety of sources, as will be detailed in the full forthcoming financial feasibility analysis. All assumptions are shown in the proformas on the following pages.

Multifamily Rental Financial Pro Forma Analysis, Walnut Creek, 2019

Development Program Assumptions

Site Characteristics	Baseline	Density Bonus
Site Size (sf)	43,560	43,560
Site Size (acres)	1.0	1.0
Development Program Characteristics		
Total Dwelling Units	100	135
Market-Rate Units	100	124
Studios	7	9
One-Bedrooms	60	73
Two-Bedrooms	33	42
Affordable Units (Very Low Income)	0	11
Studios	0	1
One-Bedrooms	0	7
Two-Bedrooms	0	3
Average Unit Size (sf)		
Studios	544	544
One-Bedrooms	641	641
Two-Bedrooms	950	950
Built Project Density (units per acre)	100	135
Net Rentable (% of gross res. area)	85%	85%
Net Rentable (sf)	73,618	99,470
Gross Building Area (sf)	86,609	117,024
Built Project FAR (excluding parking)	2.0	2.7
Total Number of Parking Spaces	118	85
Above-Ground Podium Spaces	85	85
Underground Spaces	33	-
Parking Ratio (spaces per unit)	1.18	0.63
Storage Space (sf)	5,000	-

Cost and Income Assumptions

Development Costs	
Construction Hard Costs	
Site Work, per site sf	$30
Residential (wood frame), per rentable sf	$450
Podium Parking, per space	$45,500
Underground Parking, per space	$65,000
Storage, per sf	$130
Soft Costs (as a % of hard costs) (a)	20%
Impact Fees (per unit) - baseline (b)	$28,131
Impact Fees (per unit) - density bonus (b)	$14,418
Developer Fee (as % of hard and soft costs) (d)	5%
Contingency (as % of hard and soft costs)	5%
Developer Profit (as % of total project costs)	12%
Operating Revenues & Expenses	
Rents (per unit/month) (c)	
Market-Rate Studios	$2,350
Market-Rate One-Bedrooms	$2,750
Market-Rate Two-Bedrooms	$4,050
Affordable Studios	$973
Affordable One-Bedrooms	$1,111
Affordable Two-Bedrooms	$1,239
Vacancy	5%
Operating Expenses (per unit/year)	$11,000
Construction Financing	
Loan to Cost Ratio	70%
Interest Rate	5.50%
Loan Fees	1.5%
Construction Period (months)	18
Avg. Outstanding Balance During Construction	60%
Capitalization Rate	4.50%

Development Cost Analysis

Hard Costs	Baseline	Density Bonus
Site Work	$1,306,800	$1,306,800
Residential	$33,128,100	$44,761,500
Podium Parking	$3,867,500	$3,867,500
Underground Parking	$2,145,000	$0
Underground Storage	$650,000	$0
Total Hard Costs	**$41,097,400**	**$49,935,800**
Soft costs (a)	$8,219,480	$9,987,160
Impact fees	$2,813,108	$3,797,695
Developer Fee	$2,465,844	$2,996,148
Contingency Fee	$2,465,844	$2,996,148
Total Soft Costs	**$15,964,276**	**$19,777,151**
Financing Costs		
Total Loan Amount	$39,943,173	$48,799,066
Interest	$1,977,187	$2,415,554
Points	$599,148	$731,986
Total Financing Costs	**$2,576,335**	**$3,147,540**
Developer Profit	**$7,156,561**	**$8,743,259**
Total Development Costs (Excl. Land)	**$66,794,572**	**$81,603,750**
Cost per residential sf	$771	$697
Cost per residential unit	$667,946	$604,472

Valuation Analysis

Projected Revenue	Baseline	Density Bonus
Gross Annual Income	$3,781,200	$4,853,538
Less: Vacancy	($189,060)	($242,677)
Less: Operating Expenses	($1,100,000)	($1,485,000)
Net Operating Income (NOI)	$2,492,140	$3,125,861
Capitalized Project Value	$55,380,889	$69,463,580
Less Total Development Costs	($66,794,572)	($81,603,750)
Residual Land Value	**($11,413,683)**	**($12,140,170)**
Residual Land Value/Unit	($114,137)	($89,927)

Notes:
(a) Soft costs shown here exclude impact fees, financing costs, contingency, and developer fee, each of which is calculated separtely in this proforma.
(b) Includes estimates of the following FY 2018-19 development impact fees: Parkland Dedication, Inclusionary Housing In-Lieu Fee (baseline project only), Public Art, Traffic Impact Mitigation, General Plan Fee, Walnut Creek School District Impact Fee, Acalanes Union High School District Impact Fee, County Drainage Impact Fee, and Tree Mitigation Fee.
(c) Market-rate rent assumptions are based on the January 2019 rental rates for newly-constructed multifamily rental properties in Walnut Creek, according to data from CoStar. Affordable rents reflect the affordable rent for very low-income households, assuming a household size equal to the number of bedrooms in the unit plus one and rent plus utilities equal to 30 percent of gross household income.
(d) A developer fee is included to cover the costs of managing development of project; the developer fee does not represent profit.
Source: BAE, 2019.

Townhome Financial Pro Forma Analysis, Walnut Creek, 2019

Development Program Assumptions

	Baseline	Density Bonus
Site Size (sf)	43,560	43,560
Site Size (acres)	1.0	1.0
Gross Building Area (sf)	23,040	31,180
Built Project FAR (excluding parking)	0.5	0.7
Built Project Density (units per acre)	14	19
Total Dwelling Units	14	19
Market-Rate Units	14	17
Two-Bedrooms	8	10
Three-Bedrooms	6	7
Affordable Units (Very Low Income)	0	2
Two-Bedrooms	0	1
Three-Bedrooms	0	1
Average Unit Size (sf)		
Two-Bedrooms	1,380	1,380
Three-Bedrooms	2,000	2,000
Total Number of Parking Spaces	30	23
Garage	28	19
Surface	2	4
Parking Ratio (spaces per unit)	2.14	1.21

Cost and Income Assumptions

Development Costs	
Construction Hard Costs	
Site Work, per site sf (incl. surface parking)	$22
Residential (wood frame), per sf	$275
Soft Costs (as a % of hard costs) (a)	20%
Impact Fees (per unit) - baseline (b)	$54,812
Impact Fees (per unit) - density bonus (b)	$24,835
Contingency (as % of hard and soft costs)	5%
Developer Profit (as % of total project costs)	18%
Operating Revenues & Expenses	
Sale Price (c)	
Market-Rate Two-Bedrooms	$1,040,000
Market-Rate Three-Bedrooms	$1,240,000
Affordable Two-Bedrooms	$171,533
Affordable Three-Bedrooms	$197,040
Construction Financing	
Loan to Cost Ratio	65%
Interest Rate	5.50%
Loan Fees	1.5%
Construction Period (months)	18
Avg. Outstanding Balance During Construction	60%
Marketing Costs (as a % of sale price)	6.0%

Development Cost Analysis

Hard Costs	Baseline	Density Bonus
Site Work	$958,320	$958,320
Residential Units	$6,336,000	$8,574,500
Total Hard Costs	**$7,294,320**	**$9,532,820**
Soft costs (a)	$1,458,864	$1,906,564
Impact fees	$767,365	$471,864
Contingency Fee	$437,659	$571,969
Total Soft Costs	**$2,663,888**	**$2,950,397**
Financing Costs		
Total Loan Amount	$6,472,835	$8,114,091.32
Interest	$320,405	$401,648
Points	$97,093	$121,711
Total Financing Costs	**$417,498**	**$523,359**
Developer Profit	**$1,867,627**	**$2,341,184**
Total Development Costs (Excl. Land)	**$12,243,333**	**$15,347,760**
Cost per residential sf	$531	$492
Cost per residential unit	$874,524	$807,777

Valuation Analysis

Projected Revenue	Baseline	Density Bonus
Sales Revenue	$15,760,000	$19,448,574
Less Marketing Costs	($945,600)	($1,166,914)
Less Total Development Costs	($12,243,333)	($15,347,760)
Residual Land Value	**$2,571,067**	**$2,933,899**
Residual Land Value per Unit	$183,648	$154,416

Notes:
(a) Soft costs shown here exclude impact fees, financing costs, contingency, and developer fee, each of which is calculated separtely in this proforma.
(b) Includes estimates of the following FY 2018-19 development impact fees: Parkland Dedication, Inclusionary Housing In-Lieu Fee (baseline project only), Public Art, Traffic Impact Mitigation, General Plan Fee, Walnut Creek School District Impact Fee, Acalanes Union High School District Impact Fee, County Drainage Impact Fee, and Tree Mitigation Fee.
(c) Market-rate sale price assumption based on the sale price for comparable townhomes built in Walnut Creek in 2018. Affordable sale prices reflect the affordable sale price for very low-income households, assuming a household size equal to the number of bedrooms in the unit plus one and that payments toward mortgage principal and interest, property taxes, insurance, and HOA fees total 35 percent of gross household income.
Source: BAE, 2019.

Sensitivity Analysis

BAE conducted sensitivity testing on the multifamily rental analysis shown in the proformas above to test the effect that changes to hard construction costs and market-rate rents would have on residual land values. The results of the sensitivity analysis are shown below. In all cases, all assumptions other than the assumption identified in the left-hand column were held constant as shown in the above proformas.

Table: Multifamily Rental Development Sensitivity Analysis Results

Change to Multifamily Rental Development Assumptions	Residual Land Value per Site Sq. Ft.		Residual Land Value per Unit (approx.)	
	Baseline	Density Bonus	Baseline	Density Bonus
Decreased hard construction costs to $350 per net rentable sq. ft.	$1	$77	$562	$25,000
Decreased hard construction costs to $325 per net rentable sq. ft.	$67	$166	$29,000	$54,000
Increased market-rate rents by 10 percent	Negative	Negative	Negative	Negative
Increased market-rate rents by 15 percent	$13	$63	$6,000	$20,000
Increased market-rate rents by 20 percent	$104	$177	$46,000	$57,000

Interim Findings

Key interim findings from the financial feasibility analysis include:

- The townhouse developments modeled in this analysis are financially feasible at both the baseline level and the density bonus level. Of the two townhouse prototypes, the prototype that would receive a density bonus would generate a higher residual land value than the baseline prototype, which indicates that the density bonus project would likely be more financially attractive to a developer than the baseline project.
- The multifamily rental development prototype is not feasible at either the baseline density or the density bonus level, based on current market and development conditions. Both the baseline project and the density bonus project result in a negative residual land value, meaning that a developer would not pursue either project in the current market.
- The finding that the multifamily rental development is not feasible is consistent with current development conditions in cities throughout the Bay Area, where significant recent increases in construction costs have impacted the feasibility of new multifamily rental development. While multifamily rental rates have also increased, the pace of the increase in rents has not matched the pace of the increase in construction costs. Developers and other real estate professionals expect that the current imbalance between construction costs and rents will even out over time, at which point

multifamily rental development will become more feasible. This correction will require increases in rents, decreases in construction costs, or some combination of rent increases and construction cost decreases.

- Sensitivity testing on the multifamily rental development indicates that the density bonus project generates a significantly higher residual land value than the base project in all scenarios tested that result in a potentially feasible project. This indicates that the density bonus will likely improve the financial attractiveness of the multifamily rental prototype, relative to a project at the baseline level, at a future point in time when the financially feasibility of multifamily rental development improves.